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Supreme Court, U.S.
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No. ____

IN THE

Supreme Court of the United States

OCTOBER TERM, 1992

Pacific First Bank,

Petitioner,

v.

Commissioner of Internal Revenue,

Respondent.

PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE NINTH CIRCUIT

PETITION FOR WRIT OF CERTIORARI

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QUESTIONS PRESENTED

(1) Does a reviewing court fulfill its obligation to "reject administrative constructions which are contrary to clear congressional intent," *Chevron U.S.A., Inc. v. Natural Resources Defense Council, Inc.*, 467 U.S. 837, 843, n.9 (1984), when it upholds an income tax regulation that substantially increases the effective rate of tax above the level the Conference Committee set as a compromise between the House of Representatives and the Senate?

(2) May the Commissioner of Internal Revenue reverse administrative and regulatory constructions of the Internal Revenue Code in place for more than twenty years and thereby substantially increase the effective rate of tax above the level set by Congress?

PARTIES TO THE PROCEEDING

The petitioner in the United States Tax Court and appellee in the court of appeals is Pacific First Bank, formerly known as Pacific First Federal Savings Bank. The respondent is the Commissioner of Internal Revenue[1]

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[1] The parent company of petitioner, Pacific First Bank, is Royal Trustco Ltd. which holds one hundred percent of petitioner's stock through several wholly owned corporations. Pacific First Bank does not own a significant interest in any company other than wholly owned subsidiaries.

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PETITION FOR WRIT OF CERTIORARI

Pacific First Bank hereby petitions for a writ of certiorari to review the judgment of the United States Court of Appeals for the Ninth Circuit which reversed a decision rendered in petitioner's favor by the United States Tax Court after plenary review by all active Tax Court Judges.

OPINIONS BELOW

The majority opinion of the Ninth Circuit, as amended, is reported at 961 F.2d 800 (9th Cir. 1992), and is reprinted in the Appendix at 1a-25a.[1] The dissenting member of the Ninth Circuit panel indicated that he would have affirmed the decision of the Tax Court based on that Court's opinion. The opinions of the United States Tax Court are reported at 94 T.C. 101 (1990), and are reprinted in the Appendix at pp. 26a to 51a.

[1] References to the Appendix to this petition are cited as "App. at ___a."

JURISDICTION

The judgment of the Ninth Circuit was entered on February 7, 1992. Rehearing and rehearing *en banc* were denied on May 21, 1992. This Court has jurisdiction pursuant to 28 U.S.C. §1254(1).

STATUTE AND REGULATIONS INVOLVED

The pertinent portions of the statute, 26 U.S.C. § 593, and regulations pertaining thereto are reproduced in the Appendix at pp. 52a to 58a.

STATEMENT OF THE CASE

This petition presents an important issue of federal income tax law that should be settled by this Court to achieve nationwide uniformity in the administration of those laws in the savings and loan industry. In an opinion reviewed by all active judges,[2] the Tax Court recently refused to follow the Sixth Circuit's opinion which reached the same conclusion the Ninth Circuit reached in this case.[3] Taxpayers in the Sixth and Ninth Circuits are, therefore, subject to a different rule than taxpayers in the rest of the country.[4]

The majority decision of the Ninth Circuit panel conflicts with this Court's jurisprudence regarding the standard of review of regulations. This Court has made clear that a regulation is invalid if it contravenes the intent of Congress. In spite of Congress' explicit focus on the effective rate of tax in 1969,

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[2] *Georgia Federal Bank, F.S.B. v. Commissioner*, 98 T.C. 105 (1992) (Reviewed by the Court) reprinted in Appendix at App. pp. 59a-77a.

[3] *People's Federal Savings and Loan Association of Sidney v. Commissioner*, 948 F.2d 289 (6th Cir. 1991).

[4] Under Tax Court practice, the Tax Court will follow the decisions of the Sixth and Ninth Circuits in cases reviewable by those Circuits. *Golsen v. Commissioner*, 54 T.C. 742 (1970), *aff'd* 445 F.2d 985 (10th Cir., 1971), *cert. denied* 404 U.S. 940 (1971). However, it will apply its contrary decision in cases arising in other Circuits.

the Ninth Circuit majority gave no weight to the fact that the challenged regulation "increases the effective rate of tax ... beyond the extent intended by Congress." *Pacific First*, 94 T.C. at 112. App. at 37a. The majority limited itself to inquiring whether the specific subject of the regulation had been addressed in so many words in the statute or its legislative history.

The regulation at issue in this case involves the computation of a percentage deduction for additions to a savings and loan association's bad debt reserve. The amount of the deduction is determined by two factors: a percentage and a base amount to which the percentage is applied. (Deduction = percentage x base amount.) The amount of the deduction, and therefore its impact on the effective rate of tax, depends on both factors. The challenged regulation sharply reduces the base to which the percentage applies, and thereby increases the effective rate of tax.[5]

The regulation reverses the interpretation the Commisioner had given to the statute for twenty years in rulings and regulations. The specific mechanism of this change was to reverse the order in which the deduction for additions to the bad debt reserve and the deduction for net operating loss carrybacks are applied to the income "base" arising for any given year. The Tax Court held:

> The ordering rule found in the challenged portions of section 1.593-6A(b)(5)(vi) and (vii), Income Tax Regs., does not harmonize with Congressional intent. First, the effect of the new ordering rule (proposed in 1971 (36 Fed. Reg. 15050 (August 12, 1971))) is to curtail the deduction for addition to bad debt reserve after Congress had already curtailed the deduction in 1969 and consciously rejected a proposal for a greater

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[5] This reduces the bad debt reserve Congress provided to protect the depositors of savings and loan institutions.

> curtailment. In 1969, both the House and the Senate were aware of the effective rate of the tax paid by mutual institutions and sought to increase that effective rate to different, specific extents. In conference, Congress reached a compromise, deciding upon an increase greater than that proposed by the Senate but less than that sought by the House. The new ordering rule curtails the deduction for addition to bad debt reserve by contracting the taxable income base to which the applicable percentage is applied. The new ordering rule thereby increases the effective rate of tax for mutual institutions beyond the extent intended by Congress.
>
> Second, the new ordering rule reduces the value of NOL carrybacks and is therefore plainly at odds with Congress' intent to ameliorate the effects of the 1969 curtailment by granting mutual institutions a "more generous net operating loss carryback." H. Rept. 91-413, 1969-3 C.B. at 280.

Pacific First, 94 T.C. at 112. App. at 37a.

The majority of the Ninth Circuit panel concluded, to the contrary, that Congress' failure to state specifically that it intended the rules for determining the base amount to remain unchanged (except for the minor technical modifications Congress adopted in 1969) meant that Congress had no intention regarding the size of the base. In declining to follow the Sixth Circuit's identical decision in *Peoples Federal*, Tax Court Judge Halpern observed that the Sixth Circuit approach makes Congress' hard fought compromise appear "comical" because it implies that "Congress was indifferent to the total percentage of economic income collected, overall, from the banking institutions in question: all Congress cared about was that the bad debt deduction be limited to a particular percentage of an indeterminate income base." *Georgia Federal*, 98 T.C. at 121, (Halpern, J., concurring). App. at 75a.

In refusing to follow *Peoples Federal*, the Tax Court recognized that deference to a regulation is appropriate if the intent of Congress is not clear. It held, however, that where Congress has focused explicitly on the effective rate of tax and intended to set it at a particular level, that Congressional intent controls.

This Court's decision is necessary to clarify that a reviewing court cannot, on grounds of administrative deference, approve a tax regulation which substantially increases the effective rate of tax beyond the level intended by Congress merely on grounds that Congress did not explicitly address one particular point covered by the regulation.

The regulation whose validity petitioners challenge is of great practical importance because it affects directly the tax burden of savings and loan associations located throughout the United States. The regulation impacts savings and loan associations which have experienced net operating losses and which, therefore, are most in need of the tax relief Congress intended to grant through bad debt deductions.

PROCEEDINGS BELOW

The Commissioner determined deficiencies in petitioner's tax, and petitioner filed a timely petition in the United States Tax Court.[6] In one of only eighteen decisions issued in 1990 after review by all active judges, the Tax Court held that the new regulation is invalid because it "increases the effective rate of tax for mutual institutions beyond the extent intended by Congress." *Pacific First*, 94 T.C. at 112. App. at 37a.

A majority of the three-judge panel of the United States Court of Appeals for the Ninth Circuit reversed the Tax Court.[7]

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[6] The Tax Court had jurisdiction under sections 6214(a) and 7442 of the Internal Revenue Code of 1986 as amended.

[7] The Ninth Circuit had jurisdiction pursuant to section 7482 of the Internal Revenue Code of 1986 as amended.

LEGISLATIVE AND REGULATORY BACKGROUND

A. Adoption of the Commissioner's Original Rule That the Percentage Method Deduction Should Be Computed Before Application of Net Operating Loss Carrybacks

In 1951, Congress eliminated the tax-exempt status of savings and loan associations and subjected them to income taxation. At the same time, however, Congress decided to encourage savings and loan associations to accumulate reserves against possible losses by granting them a special income tax deduction for additions to bad debt reserves. The amount of this deduction (referred to in this petition as the "percentage method deduction") is equal to the amount an association adds to its reserves, up to a statutorily established percentage of a base amount (modified taxable income). The provision was codified without substantive change as section 593 of the Internal Revenue Code of 1954.

In the original 1951 statute, and in the 1954 codification, Congress set the percentage at 100 and defined the base amount as taxable income computed without regard to the percentage method deduction itself. In regulations adopted in 1956, the Commissioner clarified that for purposes of the percentage method deduction, taxable income for any given year is calculated without regard to any other deduction the amount of which is dependent on taxable income. Treas. Reg. §1.593-1(b)(1) (1956). App. at 55a. Under the 1956 regulations, therefore, neither charitable contribution deductions nor net operating loss deductions were taken into account in calculating percentage method deductions. In 1958, the Commissioner explicitly stated that for purposes of the percentage method deduction, taxable income is calculated without regard to any net operating loss deduction that might be carried back into a year in which a taxpayer had claimed a percentage method deduction. Rev. Rul. 58-10, 1958-1 C.B. 246.[8]

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[8] For example, if a savings and loan association had taxable income of $100 in 1958 and added $100 to its bad debt reserves, it was entitled to a bad

Under the 1954 Code, savings and loan associations that were willing to put all of their income into reserves could pay no taxes and enjoyed a zero effective rate of tax. In 1962, Congress decided to subject savings and loan associations to greater taxation by decreasing the percentage method deduction. In amending section 593 in 1962, Congress focused on both the definition of the base amount and the allowable percentage. It made only a few minor technical changes in the rules for determining the base amount. It accomplished its purpose of raising the effective rate of tax by lowering the percentage from 100% to 60%.

In 1964, the Treasury promulgated new regulations. Those regulations explicitly reiterated that the base amount on which the percentage method deduction is calculated is not affected by a net operating loss carryback. Treas. Reg. §1.593-6(b)(2)(iv) (1964). App. at 56a.

B. The 1969 Congressional Compromise on Savings and Loan Tax Burden

Congress revisited the percentage method bad debt deduction in 1969. Once again, Congress was primarily concerned about the effective rate of tax paid by savings and loan associations. Both houses wanted to increase the taxes of savings and loan associations, but disagreed about how great an increase was desirable.

As it had done in 1962, Congress specifically focused its attention both on the rules determining the base amount and on the percentage. Once again it made only minor technical modifications to the rules governing the determination of the base amount. Congress worked its will to increase the tax burden on savings and loan associations by cutting the percent-

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debt deduction of $100. If in 1961 the association had a net operating loss of $30 which it carried back to 1958, its 1958 bad debt deduction remained $100, since the net operating loss carryback did not reduce its taxable income for purposes of calculating the percentage method deduction.

age of modified taxable income allowable as a deduction. The Senate bill reflected a 50% deduction while the House provided a 30% deduction. The legislation finally enacted adopted a 40% deduction and represented a compromise between the House and Senate over the appropriate level of tax for savings and loan associations.

Congress enacted no *adverse* change to the rules affecting utilization of net operating losses by savings and loan associations. Indeed, it extended the carryback period for such losses to ten years. It characterized its action as making the net operating loss provisions for savings and loan associations "more generous" and "more liberal." H.R. Rep. No. 413, 91st Cong., 1st Sess. 128-129 (1969); S. Rep. No. 552, 91st Cong., 1st Sess. 166 (1969).

C. The Commissioner's 1978 and 1979 Regulations

In 1978 and 1979, the Commissioner did an about-face.[9] He amended the regulations to provide that a savings and loan association is required to reduce the base on which the percentage method deduction is calculated (modified taxable income) by the amount of any net operating loss carryback, before calculating its percentage method deduction. By sharply reducing the base on which the deduction is calculated, the amended regulations radically reduce the value of the deduction, thereby increasing the effective rate of tax on savings and loan associations.[10]

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[9] The 1978 regulations were not retroactive and would have left the petitioner's reserves accumulated prior to the effective date of those regulations untouched. Treas. Reg. §1.593-6A(a)(5)(vi) (1978). In 1979, the Commissioner again amended the regulations to make them retroactive. Treas. Reg. §1.593-6A(b)(5)(vi) (1979). The petitioner assigned this retroactivity as a separate ground of invalidity of the regulations. The Tax Court did not reach the issue in light of its decision on the merits. The Ninth Circuit remanded the case to the Tax Court for consideration of this issue.

[10] If the amended regulations had been in force in 1961, the hypothetical savings and loan association referred to in fn. 8 above that claimed a $100 bad debt deduction in 1958 and subsequently carried a $30 net operating loss back to 1958 would have been required to reduce its bad debt deduction for 1958 from $100 to $70.

For a savings and loan association which has a sufficiently large net operating loss carryback, the effect of the new regulations is the same as if Congress had reduced the allowable percentage not to 40%, but to 0%. For example, petitioner, Pacific First Bank, calculated its deductions for annual additions to reserves for bad debts under the percentage method in the years 1971 to 1980. It sustained net operating losses in 1981 and 1982, which it carried back to the years 1971-1980. Under the Commissioner's 1979 regulations, Pacific First Bank was required to reduce to zero the taxable income base on which the percentage method deduction is calculated for every year from 1971 through 1978 when such losses were fully absorbed. The effect of the net operating loss carrybacks under the amended regulations was, therefore, to wipe out petitioner's percentage method deduction in every year from 1971 through 1978 and drastically reduce its accumulated reserve for bad debts.

ARGUMENT

A. Courts Defer To Administrative Interpretations Only If Congress Has Not Expressed Its Intent

The opinion of the majority of the Ninth Circuit panel discusses at considerable length the question of deference owed to Treasury Regulations. *Pacific First*, 961 F.2d at 803-805. App. at 12a-15a. Under any standard of deference, however, the controlling factor is the intent of Congress. A court's primary function in reviewing regulations is to ensure that the regulations implement the intent of Congress. See *Chevron U.S.A., Inc. v. Natural Resources Defense Council, Inc.*, 467 U.S. 837 (1984). Courts "defer to an administrative interpretation of a statute . . . only if Congress has not expressed its intent with respect to the question." *Presley v. Etowah County Commission*, 112 S. Ct. 820, 831 (1992). "If the intent of Congress is clear, that is the end of the matter. . . ." *Chevron U.S.A., Inc.*, 467 U.S. at 842.

B. The Ninth Circuit Erred By Ignoring Congress' Clearly Expressed Intent To Set the Effective Rate of Tax at a Specific Level

The majority of the Ninth Circuit panel did not, and could not, deny that the intent of Congress is the controlling factor in reviewing any regulation. But the majority approached the question of Congressional intent with an overly narrow focus. The majority limited itself to inquiring whether Congress had specifically addressed the old regulations and stated that it wished them to remain unchanged. Having found "no persuasive evidence that Congress gave any scrutiny to the prior regulations," *Pacific First*, 961 F.2d at 807, App. at 22a, the majority concluded that Congress had no intent with respect to the rules for determining the base on which the bad debt deduction is calculated.

But Congress did specifically focus on the effective rate of tax paid by savings and loan associations. The 1969 House and Senate Reports both contain full-page tables comparing the taxes actually paid by savings and loan associations with the taxes paid by commercial banks. *See* H.R. Rep. No. 413 (Part 1), 91st Cong. 1st Sess. at 124 (1969); S. Rep. No. 552, 91st Cong. 1st Sess. at 161 (1969). Both houses agreed that it was desirable to raise the effective rate of tax of savings and loan associations. They also agreed that this should be accomplished by decreasing the percentage used in calculating the bad debt deduction.

Congress could, alternatively, have changed the effective rate of tax by varying the base amount. As the Tax Court explained:

> Whether the percentage bad debt deduction was to be computed by taking, for example, two-thirds of 50x or one-third of 100x would have been, quite logically, immaterial with respect to the total tax sought to be collected.

Georgia Federal, 98 T.C. at 120 (Halpern, J., concurring).[11] App. at 74a.

In 1969, the rules for determining the base amount were firmly established by statute and by longstanding administrative interpretations of that statute. Congress limited itself to making very minor technical changes in the base; it gave no indication it expected a change in the established rules governing the interaction between net operating losses and the base for calculating bad debt deductions. Indeed, the only change Congress made with respect to net operating losses was to lengthen the carryback period for savings and loan associations. Its characterization of this change as providing a "more generous" net operating loss provision is reduced to cynicism by the Commissioner's unanticipated about-face.[12]

Because the effect of the deduction is determined by both the base amount to which the percentage is applied (modified taxable income) and the percentage,

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[11] Assume, for example, that in a given year under existing rules for determining the base amount, the base amount for the entire industry equals $1 billion and the statutory rate is 60%. The deduction will be $600 million.

$1 billion x 60% = $600 million

If Congress decides that $600 million is too generous and that the total deduction should be only $500 million, it has several options. It can leave the base amount untouched and reduce the percentage to 50%.

$1 billion x 50% = $500 million

It can equally well leave the percentage fixed and change the rules for determining the base so that under the new rules the base will decline to $833 million.

$833 million x 60% = $500 million

[12] H.R. Rep. No. 413, 91st Cong., 1st Sess. at 128 (1969). The amended regulations deprive savings and loan associations of between 40 and 57% of the net operating loss carrybacks which they had theretofore enjoyed.

> Congress' decision to adjust the latter is only meaningful if it presupposes a particular definition of the former. Given that there was no discussion of altering the then established rule of determining taxable income without respect to NOL's, Congress must have assumed that such rule would continue to apply.

Georgia Federal, 98 T.C. at 120 (Halpern, J., concurring).

C. The Commissioner's Regulatory Reversal Violates Congressional Intent By Raising the Effective Rate of Tax Above the Level Set By Congress

The Ninth Circuit majority's conclusion that the Commissioner could administratively reverse the rules established for more than twenty years to govern calculation of the bad debt deduction makes mincemeat of Congressional intent.[13] As the

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[13] An additional reason for holding that Congress intended the base amount to remain fixed derives from the nature of the deduction for "additions to bad debt reserves." At the time Congress enacted and amended the percentage method of calculating reserves, it had long been universally understood that an addition to bad debt reserves is an amount calculated when the addition is made and is not recalculated in light of subsequent events. *See, e.g., Rogan v. Commercial Discount Co.*, 149 F.2d 585, 590 (9th Cir.) *cert. denied* 325 U.S. 964 (1945). When Congress uses a term of art which has received a consistent judicial interpretation, there is heavy presumption that Congress has used the term in its established meaning. *See Cottage Sav. Ass'n v. Commissioner*, 111 S. Ct. 1503, 1508 (1991) (Congress is presumed to intend to codify principles which were part of the "'contemporary legal context' in which Congress enacted [a bill.]") *See also Cook v. Commissioner*, 941 F.2d 734, 737 (9th Cir. 1991); *United States v. Aguon*, 851 F.2d 1158, 1164 (9th Cir. 1988); *Miller v. Commissioner*, 836 F.2d 1274, 1282 (10th Cir. 1988). Congress in 1969 would reasonably have assumed the courts would adhere to their conclusion that the bad debt deduction must be determined when the reserve is established, not recalculated many years later when a net operating loss occurs. The amended regulations are contrary to the long established precedents regarding bad debt reserves. They are an impermissible attempt to overrule settled precedent by administrative regulation. *See Professional Equities v. Commissioner*, 89 T.C. 165 (1987) (Commissioner may not validly promulgate regulations that are in conflict with settled case law.)

Tax Court pointed out in *Georgia Federal*, the case in which the Tax Court refused to follow the Sixth Circuit decision upholding the regulation, if Congress had not intended the base amount to remain fixed,

> Congress' struggle to determine the most appropriate extent of the bad debt deduction must seem quite comical. As the Sixth Circuit sees the matter, Congress was indifferent to the total percentage of economic income collected, overall, from the banking institutions in question: all Congress cared about was that the bad debt deduction be limited to a particular percentage of an indeterminate income base.
>
> The facts belie the Sixth Circuit's apparent conclusion that Congress has acted in that irrational a manner. In 1969, it was settled that taxable income [the base on which the bad debt deduction is calculated] was determined without taking NOL's into account. Congress' computations, discussions, and the eventual compromise must necessarily have been based upon that understanding of what taxable income meant.

Georgia Federal, 98 T.C. at 121 (footnote omitted) (Halpern, J., concurring). App. at 75a.

The absence of specific legislative history referring to the prior regulations cannot mean that Congress intended to allow the Commissioner to change them in ways that would dramatically alter the compromise it reached over the proper effective rate of tax. "Where logical reasoning, applied to the sum of the facts and circumstances, can disclose a clear Congressional intent, [courts] are obliged to utilize that tool." *Id.* at 121, n.1. (Halpern, J., concurring). App. at 75a.

CONCLUSION

By narrowing its focus to the question of whether Congress said anything explicit about the 1964 regulations, and by failing to consider Congress' primary concern with the effective rate of tax, the majority of the Ninth Circuit panel failed to fulfill its mission of insuring that the central intention of Congress regarding the 1969 rate compromise be implemented. This Court should grant a writ of certiorari in this case to clarify that a reviewing court must not permit deference to an administrator's reversal of position to alter fundamentally the expressed and closely negotiated intention of Congress to achieve a specific effective rate of tax for the savings and loan industry.

Respectfully submitted,

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